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In the Supreme Court of the United States

OCTOBER TERM, 1940

NEW JERSEY AUTOMOBILE CLUB, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Claims (Pet. 18–27) is reported at 181 F. Supp. 259.

JURISDICTION

The judgment of the Court of Claims was entered on March 2, 1960 (Pet. 18), and a timely petition for rehearing was denied on May 4, 1960. The petition for a writ of certiorari was filed on June 11, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether the court below erred in sustaining the Commissioner's determination that taxpayer's method

of accounting for prepaid membership dues did not clearly reflect its annual taxable income; and that the dues were includible in taxpayer's gross income in the years received and in the amounts received, undiminished by estimated anticipated expenses to be incurred in later years.

STATUTE AND REGULATIONS INVOLVED

Sections 41, 42(a), 43, and 48 (a) and (c) of the Internal Revenue Code of 1939, and Sections 29.41–1, 29.41–2, and 29.42–1(a) of Treasury Regulations 111, are set forth in the Appendix, *infra*, pp. 7–10.

STATEMENT

Taxpayer, an automobile club, kept its books and filed its Federal income tax returns for the years 1947, 1948 and 1949, on the calendar year basis and on the accrual method of accounting. The principal part (approximately 85%) of its income was derived from membership dues which were payable at the beginning of each membership year, and which entitled the member to the benefit of various services provided by the taxpayer. (Findings 1, 3, 4, 8, 10.)

Upon receipt, the dues were commingled with all other cash receipts and deposited in taxpayer's general bank account. The record of membership dues received, however, was maintained in a "Dues" account as a liability in taxpayer's general ledger. At the end of each tax year the taxpayer closed this account and transferred part of the balance in it to another liability account, called a "Reserve for Members" account. (Pet. 21; Finding 11.)

Taxpayer's method of establishing this reserve and deferring its income was to prorate $\frac{1}{12}$ of the annual dues received in each month of the service membership. In this way it sought to reserve on its books a part of the taxable year's income to meet obligations to its members (under their membership contracts) which experience presumably had shown would arise in the following year before the expiration of the membership contracts. (Pet. 22.)

The income from dues reported by the taxpayer in each of its tax returns for 1947 through 1949 did not include the amount transferred each year to the "Reserve for Members" account. On the other hand, the taxpayer's annual system of bookkeeping resulted in its including in the income shown on its tax returns for each of the years 1947 through 1949 income from dues which it had actually received in the immediately preceding year. (Pet. 22; Finding 12.)

The Commissioner of Internal Revenue disallowed the taxpayer's deferral of income from one year to another and, by restoring the deferred income to the year in which it was received by taxpayer, determined that it owed additional taxes for the years in question in the amount of $5,388.64. Taxpayer paid these taxes, plus interest, and filed timely claims for refund which the Commissioner denied. (Pet. 22; Findings 13 and 14.)

The Court of Claims found that the method of accounting used by taxpayer, both in keeping its books of account and in reporting its Federal income tax for the years 1947, 1948 and 1949, did not clearly re-

flect its income. (Finding 15.) Accordingly, the court held that taxpayer was not entitled to recover and entered judgment dismissing the petition." (Pet. 27.)

ARGUMENT

The decision below is governed by and is in accord with *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180. It was there held (353 U.S. at 188–190) that since the taxpayer's method of deferring portions of prepaid membership dues to years subsequent to the years of receipt was "artificial," the Commissioner had discretionary authority under Section 41 of the Internal Revenue Code of 1939, Appendix, *infra*, p. 7, to reject the taxpayer's method of accounting and to require the income to be reported in the years it was received. In the instant case, as the court below pointed out (Pet. 22–23), the taxpayer employed "the same method of treatment" of prepaid membership dues as did the taxpayer in *Automobile Club of Michigan*.

In an effort to avoid the controlling effect of the decision in *Automobile Club of Michigan*, the taxpayer fails to address itself to the critical question—dispositive of this case and decided adversely to it below—of whether its method of accounting clearly reflected its taxable income. Instead, it seeks to raise the question of whether, if its method of accounting had clearly reflected income, it would be justified in departing from the fundamental rule that items of gross income and of deduction are to be accounted for on an annual rather than a transactional basis

(*Security Mills Co.* v. *Commissioner*, 321 U.S. 281, 287; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359), and the settled corollary principle that income received under a claim of right and without restriction as to its use must be reported in the year received (*North American Oil* v. *Burnet*, 286 U.S. 417, 424; *United States* v. *Lewis*, 340 U.S. 590).[1] The court below, applying the reasoning in *Automobile Club of Michigan*, deemed it unnecessary to pass on taxpayer's contention that it was exempt from the operation of those basic rules, in view of its conclusion—based upon a careful analysis of the evidence (Pet. 22–26)—that taxpayer's method of accounting for prepaid membership dues was artificial and bore no relation to the services which it might in fact be called upon to render for its members. The court below observed that "even if" taxpayer were "permitted" to escape the impact of the claim of right doctrine by showing that it used some other method which clearly reflected income, it made no such showing here. (Pet 22–23.)[2]

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[1] By setting up on its books a "reserve" account to reflect the cost of future services to its members, taxpayer in effect is here attempting, in violation of the annual accounting rule and claim of right doctrine, to deduct from its gross income (prepaid membership dues) for the taxable years an estimated amount of expenses which it anticipated would be incurred in later years. See *Brown* v. *Helvering*, 291 U.S. 193; *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45 (C.A. 2d), certiorari denied, 323 U.S. 780; *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C.A. 3d).

[2] See also the concurrent opinion of the court below in the case of *American Automobile Ass'n* v. *United States*, 181 F. Supp. 255 (Pet. 32–33), incorporated by reference in the opinion below (Pet. 23).

The two cases which taxpayer cites (Pet. 5–7) as showing a conflict (*Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C.A. 10th); *Schuessler* v. *Commissioner*, 230 F. 2d 722 (C.A. 5th)) were also distinguished in *Automobile Club of Michigan* (353 U.S. at 189, fn. 20), on the ground that the method of allocation employed in those cases was not an artificial one. In any event, the Court expressly refrained from passing on the correctness of those decisions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST 1960.

APPENDIX

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.* —The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in

section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *
(26 U.S.C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS..

When used in this chapter—

(a) *Taxable year.*—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * * *

(c) *"Paid or Incurred", "Paid or Accrued".*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U.S.C. 1952 ed., Sec. 48.)

Treasury Regulations, 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.41-1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined

in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42–1 to 29.42–3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 29.41–2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42–2 and 29.42–3). On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conver-

sion of the property. (But see section 29.22 (c)–5.)

* * * * *

SEC. 29.42–1. *When Included in Gross Income.*—(a) *In General.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41–1 to 29.41–3, inclusive.) * * *

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